VOLUME 3, ISSUE 4
FEBRUARY 2011

ISSUE BRIEF

OKPOLICY.ORG

Oklahoma Policy Institute

FIXING THE SALES TAX: OPTIONS FOR REFORM

BY DAVID BLATT, DIRECTOR

SPECIAL POINTS OF INTEREST

- Even as the economy recovers, state and local governments face serious and extended gaps between public needs and financial resources to meet them;
- The sales tax is the largest single source of state and local tax revenue but is increasingly falling short;
- Shifts in the economy from goods to services have left a decreasing percentage of sales subject to the sales tax;
- The state's inability to tax many online sales creates an unfair subsidy to out-of-state businesses and estimated annual revenue loss of $156.3M by 2012;
- Statutory exemptions to the sales tax result in annual lost revenue of nearly $4.0 billion;
- Broadening the base of the sales tax would make our tax system less arbitrary, more stable, and better adequate to long-term needs.

Even as Oklahoma's economy and revenues rebound from the recent national recession, state and local governments continue to struggle with serious and extended gaps between public needs and the resources it takes to meet them. And the end is not in sight: state revenue collections may not return to their 2007 levels by 2014.[1] Even when revenues have fully recovered, state and local finances will be under great strains due to the long-term costs of a rapidly aging population, unfunded pensions obligations, decaying public infrastructure and other factors.

This strong likelihood of extended fiscal stress creates the need to consider changes to Oklahoma's revenue system so it can support the cost of essential public services over time. While all major taxes deserve careful scrutiny, the need to update and reform the sales tax is especially urgent.

The sales tax is Oklahoma's single largest revenue source for state and local governments. At the state level, the general sales tax generated almost $2.1 billion in Fiscal Year 2008 (the most recent year for which statistics are available). That represented just over one dollar of every four in state tax collections. County and municipal general sales taxes brought in just over $1.5 billion in FY '08, or slightly less than two out of every five local tax dollars.[2] While state and county governments have a more diversified revenue base, cities, which are prohibited from assessing property or income taxes, depend most heavily on the sales tax to fund services.[3]

While the sales tax is a cornerstone of state and local revenues, the tax is increasingly falling short as a revenue source for three reasons:

- The types of purchases on which the sales tax is levied are declining as the US moves from an economy dominated by consumption of tangible goods to a service -driven economy, leaving untaxed many services which did not exist or make up a large part of spending when the sales tax began;
- A growing number of purchases are made online, where collecting taxes even on items that are supposed to be taxed presents serious challenges;

- Revenue is being eroded by legislators granting an increasing array of sales tax exemptions.

The cumulative effect is that while the sales tax is designed to be a tax on consumption, over time, an ever- decreasing share of purchase are subject to the tax. One report found that just 35.7 percent of all sales in Oklahoma in 2003 remained subject to the sales tax, compared to 52.0 percent in 1990.[4]

While there have been longstanding calls to reform the sales tax, the issue has gained growing attention of late. The Legislature in 2010 approved a measure to facilitate collection of taxes owed on Internet sales, as will be discussed below. The 2010 Oklahoma Academy Town Hall, which focused on municipal government, recommended broadening the sales tax to include appropriate and practical services, and to review all sales tax exemptions.[5] In addition, the final report of the Legislative Task Force on Municipal Finances that met in late 2010 recommended reviewing sales tax exemptions and supporting efforts to collect sales and use taxes owed.[6]

This paper will examine proposals to address each of the three reasons contributing to the erosion of the sales tax by: 1) broadening the sales tax to cover more services; 2) expanding collection of taxes on Internet sales, and 3) eliminating exemptions on currently untaxed goods. We will explore the merits and drawbacks and estimate the potential revenue of each approach.

It is important to point out that any broadening of the sales tax could be designed to increase net revenues. Alternately, tax reform could be designed in a revenue-neutral fashioned by coupling a broadening of the sales tax with a reduction of the sales tax rate or, if the current rate were kept, reducing other taxes. This choice will have a crucial impact on how any proposal ultimately affects taxpayers and the capacity to provide public services. However, whichever approach is adopted, addressing the problems with the sales tax will make the tax system less arbitrary and leave state and local governments better equipped for the ongoing challenges of funding public services.

1. Taxing Services

Although 45 states levy a sales tax, most do not apply it to most services. Of 168 services identified by the Federation of Tax Administrators (FTA) in 2007 as potentially taxable, states on average assess sales tax on 55. Hawaii, New Mexico, South Dakota and West Virginia are the exceptions among states in taxing services comprehensively. Several other states, including Arkansas, Connecticut, Iowa, Kansas, Mississippi, Nebraska, Texas and Wisconsin, as well as the District of Columbia, tax a large number of selected services. These states widely tax utilities, admissions/amusements and labor and repair services, but leave professional services — such as legal fees — largely untaxed.[7]

TABLE 1
Services Currently Taxed in Oklahoma, by category

Transportation
Income from Intrastate Transportation of Persons
Income for Taxi Operations

Storage
Automotive Storage

Utility Service- Industrial Use
Intrastate Telephone and Telegraph
Interstate Telephone and Telegraph
Electricity
Natural Gas
Other Fuel (including heating oil)

Utility Service - Residential use
Intrastate Telephone and Telegraph
Interstate Telephone and Telegraph

Services- Personal Services
Tuxedo Rental

Services- Business Services
Commercial Linen Supply
Photocopying Services
Photo Finishing
Printing

Computer
Software- Packaged or Canned Program
Software- Modifications to Canned Program
Software- Custom Programs- Material

Automotive Services
Parking Lots and Garages

Admissions and Amusements
Pari-mutuel Racing Events
Amusement Park Admission and Rides
Billiard Parlors
Bowling Alleys
Circuses and Fairs- Admission and Games
Admission to School and College Sporting Events
Membership Fees in Private Clubs
Admission to Cultural Events
Pinball and Other Mechanical Amusements
Admission to Professional Sports Events
Rental of Video Tapes for Home Viewing

Leases and Rentals
Personal Property, Short Term (Generally)
Personal Property, Long Term (Generally)
Bulldozers, Draglines and Const. Mach., Short Term
Bulldozers, Draglines and Const. Mach., Long Term
Rental of Hand tools to Licensed Contractors
Short-Term Automobile Rental
Limousine Service (With Driver)
Aircraft Rental to Individual Pilots, Short Term
Aircraft Rental to Individual Pilots, Long Term
Hotels, Motels, Lodging Houses

Fabrication, Installation and Repair Services
Repair Material, Generally

Source: Federation of Tax Administrators, Sales Taxation of Services: 2007 Report. Available at: http://www.taxadmin.org/fta/pub/services/services.html

Oklahoma is typical among the states in applying the sales tax to only a small range of services. The FTA survey shows Oklahoma as taxing 32 of 168 services. The categories of services which are most likely to be taxed in Oklahoma are utility services for industrial use (e.g. electricity, natural gas and telephone, but not water), residential phone services, admissions and amusements (e.g. bowling alleys, club memberships and video tape rentals) and leases and rentals [see the full list in Table 1, previous page]. Among services that are frequently taxed in other states but remain exempt in Oklahoma are residential utilities, repair labor, auto services and washing, long-term automobile leases, service contracts, cable television and overnight trailer park rentals.

There are several strong arguments in favor of expanding the sales tax to more services:[8]

- ***Taxing services more broadly is essential to maintaining the long-run adequacy of the sales tax.*** The long-term shift of consumption from goods to services is highly unlikely to be halted or reversed, which means a continuous erosion of revenue for states and local governments absent policy changes. The alternative to expanding the kinds of purchases subject to sales tax base is to continue to raise the tax rate. This option is constrained, however, by the limits of voter support for combined sales tax rates that are nearing 10 percent in Oklahoma and many other states, and by the ease which consumers can shift purchases to remote retailers (Internet, catalogs) where states are constrained in their ability to collect taxes (see the discussion below).

"The long-term shift of consumption from goods to services is highly unlikely to be halted or reversed, which means a continuous erosion of revenue for states and local governments absent policy changes. The alternative to expanding the kinds of purchases subject to sales tax base is to continue to raise the tax rate.

- ***Taxing services would make the sales tax more economically fair and rational.*** Since the sales tax is intended to be a general tax on consumption, there is little reason to tax the consumption of goods but not of services, which in fact can be substitutes for one another. For example, someone who buys carpet cleaning supplies pays sales tax; someone paying a carpet cleaning service does not. This inequity distorts resource allocation throughout the economy by creating an artificial incentive to purchase untaxed services rather than taxed goods. In addition, since many services are purchased primarily by more affluent households, the failure to tax services shifts more taxes to middle-class and lower-income people and makes the tax system more inequitable.
- ***Taxing services will likely make the overall tax system more stable.*** The sales tax base is dominated by purchases of big-ticket durable goods, such as cars, appliances and furniture, which often decline sharply during an economic downturn. By contrast, research suggests that the purchase of services does not rise or fall as sharply over the course of a business cycle. This means sales tax revenue would fluctuate less if more services were included under sales tax.

In exploring options for expanding the sales tax to services, a key policy question concerns whether to tax all categories of services, or to limit the tax to services that are consumed primarily by *households* rather than *businesses*.

Most economists and tax specialists, from across the ideological spectrum, caution against taxing businesses' purchases, whether goods or services, that go into the production of other goods and services. This is because of the risk of "tax pyramiding," in which taxes are passed on to consumers in the form of higher costs. Taxing business purchases also creates the risk of making local businesses less cost-competitive compared to those based in other states, and could lead a business that makes substantial purchases of taxable services to expand or shift production to states that exempt these services.

As a result of these concerns, the Center on Budget and Policy Priorities, a Washington-based organization that has done considerable research on state tax and budget issues, recommends that states assess services consumed primarily by households (such as hair salons, bowling, and health clubs), while exempting services consumed primarily by businesses (such as advertising, payroll processing, and accounting).[9]

How Much Revenue Could Taxing Services Generate?

There have been two attempts to generate estimates of the potential state revenue for Oklahoma from extending the sales tax to more services.

In his study on taxing services, Michael Mazerov of the Center on Budget and Policy Priorities calculated the potential revenue of expanding the sales tax to cover services that are primarily consumed by households, rather than by businesses. Mazerov used federal government statistics that break out household purchases of services to arrive at total purchases of "readily-taxable" services. Since this data is national, he applied each state's share of national income to these purchases and then applied the state's sales tax rate to generate a state-specific revenue estimate. Mazerov calculated the potential additional state tax revenue for Oklahoma from taxing all readily-taxable services as $792 million as of 2007.[10] This would also roughly equate to an additional $580 million for local governments in Oklahoma.

However, Mazerov acknowledges that this estimate is likely overstated in two respects.

- First, his calculations assume no taxation of existing services, though some household services are already subject to taxation. Table 2 shows that 10 of the 40 household services Mazerov categorizes as "household services" are now taxed in Oklahoma. As a result, it is unclear how much of the $792 million in estimated potential revenue is already being collected.
- Secondly, imposition of a 4.5 cent to 9 cent increase in the sales price (depending on whether local governments piggybacked on the state tax) would lead to some shift in consumer behavior and to compliance and collection issues.

On the other hand, Mazerov's estimates may be understated in that even if the sales tax were as-

TABLE 2

Taxation of Selected Household Services

Service	Taxed in Oklahoma?
Veterinary Services	No
Horse Boarding/Training	No
Pet Grooming	No
Landscaping/Lawn Care	No
Self Storage	No
Marina Services	No
Residential Electricity	No
Residential Gas	No
Investment Counseling	No
Barber Shops/Salons	No
Carpet/Uphol. Cleaning	No
Dating Services	No
Diaper Service	No
Garment Alter./ Repair	No
Health Clubs	No
Laundry/Dry Cleaning	No
Personal Instruction	No
Shoe Repair	No
Swimming Pool Clean.	No
Tuxedo Rental	Yes
Exterminating	No
Auto Washing	No
Auto Road Svc./Towing	No
Auto Maint./Painting	No
Parking Lots/Garages	Yes
Auto Rust proofing	No
Pari-mutuel Racing Adm.	Yes
Amusement Park Adm.	Yes
Bowling Alleys	Yes
Cable TV	No
Circus/Fair Adm.	Yes
Private Club Membership.	Yes
Cultural Event Adm.	Yes
Prof. Sports Adm.	Yes
Private Limo Service	Yes
Labor Chg., Auto Repair	No
Labor Chg., Remodeling	No
Extended Svc. Contracts	No
Installation Charges	No
Total Yes	10

Source: Michael Mazerov, Expanding Sales Taxation of Services: Options and Issues, Center on Budget and Policy Priorities, August 2009, online at http://www.cbpp.org/cms/index.cfm?fa=view&id=2888

TABLE 3 Services Recommended for Taxation by the 2002 Oklahoma Tax Reform Task Force	
Sector	**Sales and Use Tax Base FY - 2003 ($000)**
Landscape and Horticultural Services	296,543
New Residential Structures	2,504,954
New Industrial and Commercial Buildings	2,670,265
Resale Exemption for materials purchased	(2,660,873)
Resale Exemption for subcontracted work	(1,418,360)
New Utility Structures	991,566
Maintenance and Repair- Residential	731,345
Maintenance and Repair Other Facilities	1,685,331
Insurance Agents and Brokers (Commission Only)	998,222
Real Estate (Excluding Rent)	319,037
Laundry- Cleaning and Shoe Repair	345,211
Portrait and Photographic Studios	79,630
Funeral Services and Crematories	130,758
Miscellaneous Personal Services	554,848
Advertising	81,441
Other Business Services	1,778,143
Photofinishing- Commercial Photography	154,662
Services to Buildings	418,244
Detective and Protective Services	244,347
Automobile Repair and Services	680,538
Electrical Repair Services	158,916
Watch- Clock- And Jewelry and Furniture Repair	39,389
Miscellaneous Repair Shops	646,323
Motion Pictures	246,926
Theatrical Producers- Bands Etc.	253,617
Bowling Alleys and Pool Halls	10,833
Commercial Sports Except Racing	185,971
Racing and Track Operation	106,826
Amusement and Recreation Services	248,407
Membership Sports and Recreation Clubs	124,746
Legal Services	1,664,085
Engineering Architectural Services	1,601,657
Accounting- Auditing and Bookkeeping	1,038,143
Management and Consulting Services	1,337,227
Total	18,248,918
Source: Office of State Finance, prepared for the Legislator and Citizen Task Force on Tax Reform, April 2002 Tax base based on IMPLAN economic impact modeling system	

sessed only on services primarily consumed by households, the new taxes would invariably still affect some businesses purchasing the selected services, which would generate additional revenues.

One downside to taxing more services is that in addition to purchases that might be considered as discretionary and that are consumed primarily by the more affluent (for example, dry cleaning, horse boarding and investment counseling), it would expand the sales tax to some essential household purchases. In particular, the list of currently-untaxed household services in Oklahoma includes residential utilities, such as electricity, gas and water. The sales tax would also potentially apply to purchases such as hair cuts, car repairs and veterinary services that would affect a broad segment of the population. Coupling an expansion of the sales tax with an increase in low-income tax credits, or removing the sales tax on groceries, could help address tax equity concerns.

The second estimate of revenues from taxing services was prepared by the Office of State Finance and Oklahoma Tax Commission in 2002 for a Task Force recommending changes to Oklahoma's tax system.[11] The Task Force recommended taxing 32 new services (see Table 3). The scope of this list was considerably broader than household services, as it included purchased made primarily by businesses, such as legal services, accounting, non-residential maintenance and repairs, and others.[12] On the basis of data from the IMPLAN economic impact modeling system, this proposal was estimated to generate an additional $821 million. Given that Oklahoma's economy is more than 50 percent larger now than it was in 2002, the revenue potential of taxing services would be considerably greater than that today.

2. Enhancing Collections on Online Sales

When purchases of taxable goods are made in-state, sales tax is collected directly by the retailer. When purchases are made of the same taxable goods out-of-state – whether via the Internet, catalogs or other sellers – a companion to the sales tax called a "use tax" is still legally owed by the purchaser. However, as a result of a pair of US Supreme Court cases, the most recent of which was *Quill Corp vs. North Dakota* (1992), retailers who lack a physical presence in a state cannot be required to collect and remit use tax owed to the state.[11] That has meant that an online retailer like Target.com, which has brick-and-mortar stores in Oklahoma, collects sales tax on online purchases from Oklahomans, while online retailers such as Amazon.com do not.

The challenge states face in collecting taxes legally owed to them has several unfortunate consequences. The most significant, perhaps, is that the differential tax treatment puts local "Main Street" retailers at an unfair competitive disadvantage compared to online sellers of the same goods. In Oklahoma, the discrepancy makes a $50 pair of shoes ordered at Overstock.com $3 to $4.50 cheaper than the same shoes bought at Dillard's. Since lower income people are less likely to own computers or have credit cards required to make purchases online, differential treatment also worsens the inequities of the sales tax.

For state and local governments, the inability to collect taxes that are due has led to considerable and increasing lost tax revenue. Nationwide, state and local governments lost $7.5 billion in sales tax to e-commerce in 2009, according to a study by economists at the University of Tennessee. Lost revenue would be expected to reach at least $13.4 billion in 2012, the researchers said. For Oklahoma, lost state and local revenue was estimated at $92.7 million in 2009, rising to $156.3 million in 2012.[14]

> "The most significant consequence, perhaps, is that the differential tax treatment puts local "Main Street" retailers at an unfair competitive disadvantage compared to online sellers of the same goods.

The most comprehensive and effective solution to the problems created by the *Quill* decision would be for Congress to pass legislation authorizing states to require use tax collection by non-physically-present remote sellers. Bills to that effect are introduced annually in Congress (for many years, Oklahoma Rep. Ernest Istook was the lead author), but despite strong support from state and local governments and significant segments of the business community, federal efforts have stalled.

Left to their own devices, Oklahoma and other states have made various attempts to level the playing field for businesses and consumers by trying to collect taxes legally owed on remote purchases. Oklahoma several years ago added a line and lookup table on the state income tax form to remind taxpayers of their use tax obligations. In 2010, the state took additional steps to encourage use tax collection as part of a package of revenue measures adopted to balance the budget and mitigate the severity of cuts to services.[15] These included:

- A requirement that remote sellers disclose to their consumers that they may owe use tax on what they are buying despite the fact that the seller is not collecting the tax;
- A requirement that paid income tax preparers must tell their clients that they may owe tax on what they bought online;
- Language clarifying that some Internet sellers ought to be collecting sales tax because they have a related store in Oklahoma acting on their behalf.

The Oklahoma Tax Commission projected that these measures would generate an additional $35 million in state sales tax revenue in FY '11.

Oklahoma, however, stopped short of emulating key provisions of laws enacted by other states in recent years.[14] Under a recent Colorado law, remote sellers must send a report to their customers at the end of each year of the total amount of purchases they made from that seller over the year broken down by categories. This requirement can be helpful to customers who otherwise must rely on old invoices and statements to know their use tax liability. Colorado also requires remote sellers to report the total annual purchases of their customers to the state Tax Commission annually. This provision was in an initial version of the Oklahoma legislation but was withdrawn after vocal opposition emerged .

The most aggressive state efforts in this area have aimed at expanding the definition of “nexus” or physical presence in the state to encompass more retailers without running afoul of *Quill*. The US Supreme Court has made clear that the “physical presence” requirement can be satisfied by the in-state presence of third parties working *on behalf of* the remote seller. Three states - New York, Rhode Island and North Carolina - have passed laws asserting that relationships such as an affiliate program, in which a company like Amazon pays independent websites commission for providing links that result in sales, are sufficient to establish nexus.

Some online retailers have fiercely resisted these enhanced collection efforts, with Amazon having gone so far as to discontinue its affiliate programs in several states in retaliation. Thus far, however, appeals courts have upheld the states’ efforts to require or strongly encourage online retailers to collect sales tax. As Michael Mazerov of the Center on Budget and Policy Priorities has argued, if states hang tough against threats from Amazon and the like, they are likely to prevail:

> Internet retailers that suspend their affiliate programs likely will make fewer sales in those states, and some of the sales they lose will shift back to in-state stores (thereby boosting the local economy) or shift to other Internet retailers that have always collected the state’s sales tax or begin doing so under the new law.[17]

Unless Congress adopts a nationwide solution to the problem, a significant share of remote sales likely will remain untaxed. Yet the interest of collecting enough revenue to pay for essential state and local public services and the interest of promoting a level playing field for local businesses and their customers should encourage Oklahoma to pursue every means at its disposal to continue to chip away at the problems of untaxed Internet sales.

The Download Lowdown

Oklahoma is among 21 states that do not collect sales tax on downloaded music, video games and books, and among 12 that do not tax downloaded computer programs, according to data collected by the Center on Budget and Policy Priorities. Here the issue primarily concerns not the location of the seller but the laws of the state. For example, iTunes charges tax on music downloads in all states where they are taxable, but not in Oklahoma and the others that exempt such purchases.

This creates a situation where no sales tax is paid on digital downloads while the same product – a computer program, book, CD or video – purchased from a store is taxed. Again, in addition to costing the state lost revenue, this puts local merchants at a disadvantage and increases the tax paid on those who are less likely to have computers, high-speed Internet access and credit cards. Oklahoma should consider changing its law to tax all online goods and services if the comparable “real world” purchase is taxed.

3. Eliminating Sales Tax Exemptions

A third, complementary, approach to increasing the range of purchases subject to sales tax is to eliminate exemptions now on the books. While Oklahoma law generally applies a tax to the sales of all tangible personal property in the state, the statutes provide an extensive list of transactions for which no sales tax is due. The overall composition of the list gives the appearance of a hodge-podge of favors and privileges that seems to defy any clear or coherent rationale. The arbitrary nature of many of the exemptions, as well as the annual efforts by various entities to get added to the tax-exempt list, has spurred calls to do away with or trim the list of exempted sales.

The 2009-10 biannual Tax Ex-

TABLE 4

Revenue Impact of Oklahoma Sales and Use Tax Exemptions, FY '06, FY '08 & FY '10 (>$100,000 only)

Description	Cite	FY '06	FY '08	FY '10
Sales to manufacturers	68 OS 1359	$ 1,532,912,000	$ 1,623,110,000	$ 1,744,549,000
Sales for resale	68 OS 1357	$ 773,781,000	$ 1,493,000,000	$ 1,512,000,000
Utilities for residential use	68 OS 1357	$ 94,058,000	$ 99,592,000	$ 117,570,000
Subdivisions or agencies of state government	68 OS 1356	$ 98,929,000	$ 104,750,000	$ 114,440,000
State of Oklahoma	68 OS 1356	$ 80,376,000	$ 85,105,000	$ 92,000,000
Agricultural sales	68 OS 1358	$ 33,264,000	$ 63,905,000	$ 64,710,000
Livestock purchased outside of state	68 OS 1404	$ 45,379,000	$ 48,049,000	$ 57,949,000
Commercial airlines or railroads	68 OS 1404	$ 43,166,000	$ 45,706,000	$ 51,677,000
Advertising sales	68 OS 1357	$ 44,194,000	$ 46,794,000	$ 41,550,000
Federal food stamp program	68 OS 1357	$ 11,775,000	$ 20,731,000	$ 39,020,000
Tuition and educational fees paid to private schools	68 OS 1356	$ 18,511,000	$ 19,600,000	$ 19,464,000
Newspapers and periodicals sales	68 OS 1354	$ 13,007,000	$ 13,772,000	$ 17,000,000
Disabled veterans	68 OS 1357	$ 1,642,000	$ 12,178,000	$ 15,175,000
Water, sewage & refuses services	68 OS 1354	$ 12,061,000	$ 12,771,000	$ 13,000,000
Drugs and medical devices	68 OS 1357.6	$ 14,021,000	$ 14,486,000	$ 10,650,000
Sales tax holiday	68 OS 1357.10	-	$ 6,403,000	$ 6,839,000
Sales by schools	68 OS 1356	$ 6,058,000	$ 6,414,000	$ 6,577,000
Rural electric cooperatives	18 OS 437.25	$ 4,824,000	$ 5,108,000	$ 6,363,000
School cafeterias	68 OS 1356	$ 52,560,000	$ 5,565,000	$ 6,017,000
Churches	68 OS 1356	$ 5,370,000	$ 5,686,000	$ 5,439,000
Machinery & equipment used in manufacturing	68 OS 1404	$ 3,680,000	$ 3,897,000	$ 4,585,000
Fraternal, religious, civic, charitable or educational societies' dues	68 OS 1356	$ 3,492,000	$ 3,697,000	$ 3,567,000
Private education institutions	68 OS 1356	$ 2,681,000	$ 2,839,000	$ 3,068,000
Aircraft & aircraft parts	68 OS 1357	$ 2,078,000	$ 2,200,000	$ 2,150,000
Electricity used in enhanced recovery oil production	68 OS 1357	$ 1,600,000	$ 1,694,000	$ 1,699,000
Sales by or to cultural organizations	68 OS 1356	-	$ 96,000	$ 1,680,000
Out-of-state tax credit	68 OS 1404	$ 1,336,000	$ 1,415,000	$ 1,554,000
Horses	68 OS 1357.7	$ 1,390,000	$ 1,472,000	$ 1,170,000
Admission to professional sporting events	68 OS 1356	-	$ 691,000	$ 563,000
Tourism broker transportation services	68 OS 1354	$ 433,000	$ 458,000	$ 489,000
Sales by fire departments	68 OS 1356	$ 426,000	$ 451,000	$ 471,000
Community Mental Health Center	68 OS 1356	-	$ 82,000	$ 423,000
Funeral home transportation services	68 OS 1354	$ 505,000	$ 535,000	$ 291,000
YMCA/YWCA	68 OS 1356	-	$ 282,000	$ 286,000
Museum admission tickets	68 OS 1356	$ 262,000	$ 277,000	$ 280,000
Bad debt credit	68 OS 1407.1	$ 25,071,000	$ 212,000	$ 210,000
Organization which is part of a network of autonomous member organizations	68 OS 1356	-	$ 68,000	$ 104,000
Specialized facilities serving physically and mentally handicapped	68 OS 1356	-	$ 27,000	$ 100,000
TOTAL OF MAJOR SALES & USE TAX EXEMPTIONS		$ 2,928,842,000	$ 3,753,118,000	$ 3,964,679,000

SOURCE: Oklahoma Tax Commission, Tax Expenditure Report, 2006-06, 2007-08, 2009-10

penditure Report of the Oklahoma Tax Commission identifies some 149 sales and use tax exemptions.[18] The total revenue loss from those exemptions is over $3.9 billion a year (see Table 4 for a list of exemptions with a revenue impact exceeding $100,000). While this is an indisputably large amount, the lion's share of the exemptions – $3.2 billion, or 82 percent of the total - fall under the categories of sales to manufacturers and sales for resale. In both cases, the exemptions are based on the sound economic logic of not taxing business inputs to avoid tax pyramiding. However, the Tax Commission reports that the fiscal impact of the exemption of sales for resale nearly doubled to just under $1.5 billion in FY '08 from $774 million in FY '06. It is unclear whether this increase reflects changes in how the exemption is applied or just a different methodology in calculating or reporting the exemption). Another large exemption, totaling more than $200 million, is sales to state government and its subdivisions, which avoids the situation of the government charging tax on itself. The remaining sales tax exemptions mostly involve either economic activities that have been branded as specially favored (e.g. sales to commercial airlines and railroads, agricultural sales, newspaper sales, etc.) or sales involving groups and activities deemed socially worthy (e.g. prescription drug sales, sales to disabled veterans, sales to or by churches, food pantries, children's homes, etc.).

The same 2002 Tax Reform Task Force that recommended extending the sales tax to more services (see above) also examined existing exemptions on goods, but ultimately recommended preserving exemptions on everything other than the sale of newspapers and periodicals. Several factors undoubtedly contributed to the decisions to preserve the other exemptions, including policy principles, political considerations, and in some cases, the minimal amounts of lost revenue involved with particular exemptions.

The list of sales tax exemptions has grown rapidly. In 1980, there were six; now there are 149.[19] Since 2001, Section 1356 of Title 68 of the Oklahoma Statutes, which enumerates statutory exemptions, has added 32 subsections exempting sales for such things as homeless and abandoned children shelters, neighborhood watch associations, library construction projects, wild duck habitation auctions, and tickets to professional sporting events. Various categories of non-profit charitable associations have been especially active in recent years lobbying the Legislature seeking sales tax exemptions. In Kansas, a similar situation led to a proposal that would give the state's Department of Revenue, rather than the Legislature, the authority to determine which non-profit organizations should be granted tax-exempt status.[20]

" The list of sales tax exemptions has grown rapidly. In 1980, there were six; now there are 149. Since 2001, Section 1356 of Title 68 of the Oklahoma Statutes, which enumerates statutory exemptions, has added 32 subsections

There has been some effort made in recent years in Oklahoma to take on the ever-burgeoning list of sales tax exemptions. In particular, Senator Mike Mazzei introduced legislation in 2008 that proposed the phased-in elimination, over several years, of all sales tax exemptions. The bill passed the Senate Finance committee but was never brought up for a vote in the full Senate In 2009, Senator Mazzei introduced a narrower bill, which proposed to eliminate the sales tax exemption on newspapers, items purchased at museums, chiropractor services and several others. Mazzei's proposal provoked strong opposition from the leader of his own party in the Senate and failed to get a committee hearing. In 2010, while the Legislature acted to suspend various income tax credits as a way to generate additional revenues to limit budget cuts, repealing or suspending sales tax exemptions never received any serious consideration. This year, SB 728 would automatically sunset any new sales tax exemptions after five years.

Conclusion

The non-taxation of services and the ever-growing array of exemptions and preferential tax treatment are contributing to the growing structural deficit faced by state and local governments, where revenues are increasingly incapable of supporting core public services. There is no question that any effort to expand the sales tax base, either by taxing services, enforcing collection of taxes on online sales or doing away with existing exemptions, poses difficult policy choices and will spark fierce political battles. However, these choices and battles involved with fixing the sales tax must be confronted if Oklahoma is to have any hope of a fair and effective tax system.

An earlier version of this brief appeared as part of the 2010 Oklahoma Academy Town Hall background document. The author is grateful to Michael Mazerov, Jon Shure and Gene Perry for their helpful suggestions.

ENDNOTES

[1] Oklahoma Policy Institute, "A New Fiscal Reality: State Budget Outlook, 2011-2014", December 2010; at: http://okpolicy.org/files/newfiscalreality_brief.pdf

[2] U.S. Census Bureau, State and Local Government 2008, at: http://www.census.gov/govs/estimate/

[3] For a full discussion, see the background document and recommendations of the Oklahoma Academy Town Hall on Municipal Government, November 14-17, 2010; at: http://www.okacademy.org/current_topic.html

[4] Iris J. Lav, Elizabeth McNichol and Robert Zahradnik, Faulty Foundations: State Structural Budget Problems and How to Fix Them. Center on Budget and Policy Priorities, October 2005, at: http://www.cbpp.org/5-17-05sfp-states.htm

[5] The Oklahoma Academy, Town Hall Recommendations 2010; at: http://www.okacademy.org/PDFs/issue-brief-web.pdf

[6] The report was not made available online but was discussed in Randy Krehbiel, "Municipal task force efforts commended," Tulsa World, December 20, 2010; at: http://www2.tulsaworld.com/news/article.aspx?subjectid=16&articleid=20101220_16_A1_ULNSbp845850&allcom=1

[7] For a summary of the FTA report and state-level data, see http://www.taxadmin.org/fta/pub/services/btn/0708.html The FTA survey counts the business license tax in Delaware and the business occupation tax in Washington.

[8] This section borrows freely, with permission, from Lav, McNichol and Zahradnik, ch. 2 and Michael Mazerov, "Expanding Sales Taxation of Services: Options and Issues", Center on Budget and Policy Priorities, August 2009; at: http://www.cbpp.org/cms/index.cfm?fa=view&id=2888

[9] Ibid

[10] Readily-taxable services consist of all services consumed by households except housing, health care, education, transit, banking, insurance, legal and funeral services.

[11] The Legislator and Citizen Task Force on Tax Reform was formed on February 19, 2002 and submitted its final report and recommendations on April 12, 2002. The Task Force report is not available online.

[12] The Task Force estimated that $506 million of the $776 million generated by expanding the sales tax would be assessed on businesses.

[13] *Quill Corp. v. North Dakota* (91-0194), 504 U.S. 298 (1992); at: http://supct.law.cornell.edu/supct/html/91-0194.ZO.html.

[14] Donald Bruce, William E. Fox and LeAnn Luna, "State and Local Government Sales Tax Losses from Electronic Commerce," University of Tennessee April 2009; at: http://www.streamlinedsalestax.org/uploads/downloads/EC%20Executive%20Committee%20Meeting%20Docs/SSTP%20e-commerce%202009%20REV041309.pdf.

[15] See "An expert's take on Oklahoma's new sales tax compliance law," Oklahoma Policy Institute blog, June 2010; at: http://okpolicy.org/blog/taxes/an-experts-take-on-oklahomas-new-sales-tax-compliance-law/

[16] This section is based largely on Michael Mazerov, "New York's Amazon Law: An Effective Tool for Collecting Taxes Owed on Internet Sales, " Center on Budget and Policy Priorities, July 2009; at: http://www.cbpp.org/cms/index.cfm?fa=view&id=2876.

[17] Ibid

[18] Oklahoma Tax Commission, Tax Expenditure Report, 2006-08. October 2008, online at: http://www.tax.ok.gov/reports/2006-2008TaxExpRpt.pdf

[19] Doug Enevoldsen, "Bixby," Oklahoma Academy Town Hall on Municipal Government briefing document, November 2010, p. 116.

[20] Chris Courtwright, "Kansas Tax Panel to Consider Increased Scrutiny of Exempt Organizations", Tax Analysts, October 16, 2007

OKPOLICY.ORG

Better Information, Better Policy

Oklahoma Policy Institute (OK Policy) is a (501)(c)(3) organization that provides timely and credible information, analysis and ideas on state policy issues

OKLAHOMA POLICY INSTITUTE
P.O. BOX 14347
TULSA, OK 74159-1347
918-794-3944
DAVID BLATT, DIRECTOR, DBLATT@OKPOLICY.ORG
GENE PERRY, POLICY ANALYST GPERRY@OKPOLICY.ORG; KATE RICHEY, POLICY ANALYST KRICHEY@OKPOLICY.ORG